

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Associate Area Counsel, Manhattan (CC:LB&I:F:Man)
(Large Business & International)

from: Senior Counsel, Branch 7 (CC:ITA:B07)
(Income Tax and Accounting)

subject: Change in Method of Accounting and Section 481(a) adjustment

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Seller =

Advisor =

Date 1 =

Taxable Year One =

Taxable Year Two =

Taxable Year Three =

ISSUES

1. Whether a change from open transaction treatment (as) to realization treatment (as direct owner of the underlying assets) constitutes a change in method of accounting under section 446 of the Internal Revenue Code?
2. If the foregoing does constitute a change in method of accounting under section 446, whether a section 481(a) adjustment should be recognized in connection with such change, and whether the section 481(a) adjustment may reflect amounts attributable to closed taxable years?

CONCLUSIONS

1. A change from open transaction treatment to realization treatment constitutes a change in method of accounting under section 446.
2. An adjustment under section 481(a) is imposed when a taxpayer's method of accounting for an item is changed from open transaction to realization. The 481(a) adjustment is computed with respect to relevant amounts in all taxable years preceding the year of change, whether the taxable years are open or closed under the period of limitations on assessment ("statute of limitations").

FACTS

LAW AND ANALYSIS

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also section 1.446-1(b)(1) of the Income Tax Regulations.

The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-3 (1979); RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied 457 U.S. 1133 (1982).

Once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970); Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

An examining agent who determines that a taxpayer's method of accounting is impermissible may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting. Except as provided in section 2.06 of Rev. Proc. 2002-18, 2002-1 C.B. 678 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under section 446(e)), an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method contrived to reflect the hazards of litigation. See Rev. Proc. 2002-18, sections 3.01, 5.01 to 5.03.

An examining agent changing a taxpayer's method of accounting will make the change in a taxable year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See Rev. Proc. 2002-18, section 5.04(1).

An examining agent changing a taxpayer's method of accounting ordinarily will impose a section 481(a) adjustment, subject to a computation of tax under section 481(b) (if applicable). The section 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See section 1.448-1(c)(3); Rev. Proc. 2002-18, section 5.04(2), (3). When there is a change in method of accounting to which section 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, section 2.05(1).

What constitutes a change in method of accounting?

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in

the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the taxable year in which taxable income is reported. See Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.01(1); Rev. Proc. 2011-14, 2011-4 I.R.B. 330, section 2.01(1); Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting. General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C.Memo. 2003-95.

Although a method of accounting may exist under the definition in section 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See section 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. See section 1.446-1(e)(2)(ii)(b).

If the change in accounting practice does involve timing, then it is an accounting method change, even if it also arguably involves a change in how the item of revenue or expense is characterized, such as changing from treating transactions as sales to treating the transactions as leases. Certain cases, such as Underhill v. Commissioner, 45 T.C. 489 (1966), are sometimes read to stand for the proposition that changes involving a change in the "characterization" of an item are not accounting method changes under section 446. However, section 1.446-1(e)(2)(ii)(b) enumerates numerous adjustments that do not constitute changes in method of accounting, but contains no exception for changes that alter the characterization of an item. In fact, the

regulations include corrections of erroneous characterizations among changes in methods of accounting. See Example 11 of section 1.446-1(e)(2)(iii) (inventory to depreciable asset). See also Cargill Inc. v. U.S. 91 F.Supp.2d 1293, 1297 -1298 (D.Minn.,2000) (“Like the petitioner in Witte, Cargill has not directed the Court to any provision of the Code that sets forth such a “characterization” exception. Accordingly, the Court concludes that no such exception exists.” Citing Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975)).

Moreover, numerous cases have held that a change in characterization can be a change in method of accounting. See Diebold v. Commissioner, 891, F.2d 1579, 1583 (Fed. Cir. 1990) (held that a change in treatment from inventory to capital asset constituted an accounting method change); Cargill, 91 F.Supp.2d at 1293 (re-characterization of interest from leasehold to ownership); Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993) (re-characterizing “working gas” (inventory) to “cushion gas” (capital asset); Standard Oil Co. v. Commissioner, 77 T.C. 349, 410-411 (1981) (section 1250 property to section 1245 property); Capital One v. Commissioner, 130 T.C. 147 (2008), aff’d 659 F.3d 316 (4th Cir. 2011) (late fees from fee income to OID); Humphrey, Farrington & McClain, P.C. v. Commissioner, T.C.Memo. 2013-23 (advanced litigation expenses as deductible business expenses or loans). See also Rev. Proc. 2011-14, APPENDIX sections 2.01 (changing treatment of amounts received from Commodity Credit Corporation from gross income to loan is method change), 3.01 (changing treatment of advanced litigation costs from business expenses to loans), 6.03 (changes from sale to lease, or vice versa, are method changes).

A change in method of accounting reflecting a change in the characterization of the item of revenue or expense can also involve a change in the character of taxable income from capital gain (loss) to ordinary income (loss), or vice versa. For example, in Witte the taxpayer's shift from the cost recovery method of accounting for gain derived from the sale of real estate properties to completed transaction treatment constituted a “change in the method of accounting” within the meaning of the Treasury Regulations. While the Court found that the change involved the proper timing of a material item, the deficiency determination at issue was based on the finding that the amounts reported as long-term capital gain should be taxed as ordinary income since such amounts were in part interest income and in part income from the sale of properly held primarily for sale. Witte, 513 F.2d at 391. Diebold and Pacific Enterprises also involved changes between capital and ordinary taxable income. See also Mingo v. Commissioner, T.C.Memo. 2013-149 (change in accounting method for partnership interest sale proceeds attributable to unrealized receivables from installment method resulting in capital gain to cash receipts and disbursements method yielding ordinary income).

Where the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable. Huffman v. Commissioner, 126 T.C. 322, 354 (2006); First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987); Diebold, Inc. v. United States, 16 Cl. Ct. 193, 203-205 (1989), aff’d 891 F.2d 1579 (Fed. Cir. 1989), cert. denied 498 U.S. 823 (1990).

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes gross income for a type of revenue generally constitutes a method of accounting, and a change from one such practice to another generally constitutes a change in method of accounting. The courts have generally held that switching the time for recognizing an item of gross income constitutes a change in method of accounting within the meaning of sections 446 and 481. In Security Associates Agency Insurance Corp. v. Commissioner, T.C. Memo. 1987-317, for example, the Tax Court held that the switch from including advance insurance sales commissions in taxable income in the taxable year received to including such commissions in the taxable year earned was a change in method of accounting. Similarly, in Johnson v. Commissioner, 108 T.C. 448 (1997), the Tax Court held that switching the time for recognizing escrowed customer payments as gross income from when the escrow agent released funds to the taxpayer to when the customer gave the sale price to the taxpayer was a change in method of accounting. See generally Rev. Proc. 2011-14, APPENDIX section 15.

Similarly, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes a method of accounting, and a change from one such practice to another generally constitutes a change in method of accounting. Thus, a change from deducting officers' bonuses in the year they are declared to deducting the bonuses in the year following the declaration year constitutes a change in method of accounting (Summit Sheet Metal Co. v. Commissioner, T.C. Memo 1996-563), and a change from deducting real estate taxes when paid to deducting these taxes when incurred is also a change in method of accounting (section 1.446-1(e)(2)(iii), Example (2)). Courts have found accounting method changes in similar circumstances involving a variety of different types of expenses, including vacation pay (American Can Co. v. Commissioner, 317 F.2d 604 (2nd Cir. 1963)), interest (Peoples Bank, 50 T.C. at 750 (1968); Mulholland v. U.S., 28 Fed.Cl. 320 (1993); Prabel v. Commissioner, 882 F.2d 820 (3rd Cir. 1989)), customer rebates (Knight-Ridder v. United States, 743 F.2d at 781), and related party payables (Bosamia v. Commissioner, 661 F.2d 250 (5th Cir. 2011)).

*Whether Exam's adjustments constitute a change in method
of accounting under section 446*

These adjustments constitute a change in method of accounting because they involve the proper time for the inclusion of the item in income or the taking of a deduction. This

change does not permanently affect Taxpayer's lifetime taxable income; it merely changes the taxable years in which income and deductions are reported. Because this is a change in an accounting practice that involves the timing of when an item is included in income or when it is deducted, it constitutes a change in method of accounting. This conclusion is not changed by the fact that the adjustments in this case effectively re-characterize one type of income (long term capital gain) into several different types of income and deduction and short term gains and losses.

Section 481(a) adjustment

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also section 1.448-1(a).

A change in method of accounting to which section 481(a) applies includes a change in treatment of a single material item. See section 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder v. United States, 743 F.2d at 798; Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

Once the Commissioner has imposed a change in method of accounting, the application of section 481(a) to such change is patent and mandatory. Primo Pants Co. v. Commissioner, 78 T.C. 705 at 720; Emert v. Commissioner, T.C.Memo. 1999-175; Hitachi Sales Corp. of America v. Commissioner, T.C.Memo. 1994-159, supp. T.C.Memo. 1995-84.

An adjustment under section 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Suzy's Zoo v. Commissioner, 114 T.C. 1, 12-13 (2000), aff'd 273 F.3d 875, 884 (9th Cir. 2001); Huffman v. Commissioner, 126 T.C. 322, 341-2 (2006), aff'd 518 F.2d 357, 363-4 (6th Cir. 2008); Graff Chevrolet Co. v. Campbell, 343 F.2d at 571-572; Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983); Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968); Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds 791 F.2d 906 (Fed. Cir. 1986).

Should a section 481(a) adjustment be recognized for the accounting method change imposed by Exam? May such adjustment reflect amounts attributable to a closed taxable year?

As concluded above, the adjustments contemplated by Exam constitute a change in method of accounting. Accordingly, once imposed, the computation and recognition of an appropriate adjustment under section 481(a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change.

The section 481(a) adjustment reflects relevant amounts from any taxable years preceding the year of change (Taxable Year 2), even if such years are closed by the statute of limitations. Thus, if Taxpayer earned amounts in Taxable Year 1 under its old method of accounting that it did not include in its Taxable Year 1 tax return, then positive amounts (increases to taxable income) will be recognized under section 481(a) to eliminate the omission that would otherwise result, despite Taxable Year 1 being now closed under the statute of limitations.

Earthquake Sound Corp. v. Commissioner, T.C.Memo. 2000-112 (section 481(a) adjustment to eliminate duplicated deductions resulting from accounting method change could be imposed even though related years in which duplicate deductions were taken have been closed by the statute of limitations).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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